14 April 1999

Dr Alan Preston
Secretary
Review of Business Taxation
Department of Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

A Platform for Consultation – Third Submission

We refer to submissions made by Lend Lease of 29 March and 1 April 1999 on the second discussion paper released by the Review of Business Taxation ("RBT" or "the Review") titled ***A Platform for Consultation***. This third submission is made jointly by Lend Lease and its wholly owned subsidiary MLC Limited and on behalf of MLC Lifetime Company Limited. The MLC Group has $28 billion in assets under management and, in addition to its funds management business, is Australia's second largest life insurance group.

This Lend Lease/MLC submission is concerned with the proposals contained in Chapters 34 to 37 of ***A Platform for Consultation*** regarding the taxation of life insurance. Our detailed comments in relation to the Review's proposals are contained in the attached appendix.

Lend Lease/MLC welcomes the opportunity to participate in the review process and fully supports the aims of the Review. We appreciate the consultative process and the availability of the Review staff to meet and discuss issues.

Life Insurance Taxation

In relation to policyholders, Lend Lease/MLC's views are as follows:-

- Holders of life and superannuation policies which, by their nature, benefit from special tax treatment, i.e. superannuation policies, annuities, retirement savings accounts, should be excluded from the effects of the proposed Business Entity Tax Regime for the reasons outlined in detail in Lend Lease's first submission to the Review.

- The taxation of policyholders should, in the interests of competitive neutrality, be benchmarked against the tax treatment applying to individuals either investing directly or via other Collective Investment Vehicles (“CIVs”). Specifically, life company policyholders:

  (i) should not be taxed on unrealised gains;

  (ii) should be allowed CGT treatment in respect of assets held by the life company for their benefit (in the event that indexation continues or that specific CGT concessions are introduced for individuals); and

  (iii) should not be taxed on tax preferred income (unless a decision is made by the Government to remove tax preferences for **all** taxpayers); this is consistent with the position contained in our letter on “Treatment of Tax Preferences” dated 12 April 1999.

- Interest expense associated with borrowing for investment in life policies should be deductible in the hands of policyholders.

- To enable life companies to properly carry out their fiduciary responsibilities to policyholders, Lend Lease/MLC recommends that the date of the commencement of the proposed tax system should be deferred by 12 months, to 1 July 2001.

In relation to shareholder profits, life companies should be taxed in a similar way to other corporate bodies and business entities generally.

However, we have two concerns:-

- The proposed formulae for the calculation of a life company’s taxable income will not result in the calculation being carried out on a sufficiently fair and robust basis – unless certain modifications are made; and

- The tax change proposed for shareholders is significant. Accordingly, Lend Lease/MLC believes there are strong grounds for reasonable transitional rules. This is supported by:-

  (a) the magnitude of the tax change – an increase from, on average, 20% at present to 30% (or 36%), which represents an increase of between **50% to 80%** in the shareholders’ tax burden;

  (b) the fact that similar substantial tax changes to both friendly societies and credit unions have been "phased in", and

  (c) the potential for unintended flow-on effects to policyholders, as shareholders seek to maintain their return on equity requirements.

Superannuation Policyholders

Lend Lease's first submission to the Review contained a strong focus on the need to exclude Pooled Superannuation Trusts and all life company superannuation business from the Business Entity Tax Regime – in order to preserve the current competitive neutralities and not materially disadvantage millions of superannuation investors.

Non Superannuation ("Ordinary") Policyholders

Lend Lease/MLC accepts that investment returns on Ordinary policies should ultimately be subject to tax at the policyholder's marginal rate – i.e. as for other investments (collective or direct).

Equally, where bonuses are assigned only on the termination of policies, the life company should pay a withholding tax at the corporate rate on realised investment income accruing to policyholders within the company.

It is important, however, that such a withholding tax and the tax ultimately included in a policyholder's assessment are determined on the same basis as for individuals investing directly in investment markets or via other CIVs. In particular, competitive neutrality suggests that a life company should be allowed to pass on to its Ordinary policyholders concessions available to individual investors in respect of unrealised gains, and indexation on realised gains and the flow through of tax preferred income to the extent that these are to continue.

In addition, policyholders investing in policies with assessable bonuses, whether annually or on termination, should be able to claim interest deductions on any borrowings for such investment. This is to be consistent with the treatment presently available to investors in other CIVs.

Life Company Taxable Income

The RBT discussion paper proposed three options for calculating a life company's taxable income. Lend Lease/MLC supports Option 1, subject to our suggested modifications.

The main advantage of this approach is that it can readily be applied to **all** of a life company's business.

The approach is similar to that currently applicable to Retirement Savings Accounts ("RSAs"). The effect is for:

- Policyholders to be taxed on income allocated to their policies; and
- Shareholders to be taxed on **all** other income including fees.

One modification suggested is to adopt the Solvency Requirement for Policies ("SRP") for the purpose of the "change in actuarial liabilities" item, rather the current balances of policyholder accounts or Current Termination Values ("CTVs"), which effectively applies under the RSA tax basis.

The SRP is equal to the CTVs together with prudential margins, and is calculated on a statutorily prescribed basis. Use of a calculation of policy liabilities including prudential margins is consistent with the basis of taxation of General Insurers.

Other modifications are required to ensure that:-

- tax is not levied on unrealised gains,
- fees deductible from policyholders' returns are not double counted in the calculation of life company income,
- concessional rates of tax are levied on income attributable to policyholders eligible for such concessions,
- the increase in policyholders' liabilities includes current and deferred taxation attributable to policyholders.

Income and Expense Apportionment

We are aware that the Review's aim is to ensure that the basis of calculating taxable income – both for policyholders and shareholders – is robust, and free of opportunity for manipulation.

We support this aim. We strongly believe that the recommendations in this submission provide the robust basis desired, with all investment income apportionments subject to formulae that are both logical and not able to be manipulated.

With regard to expenses, those allowable would be deductible to shareholders at the corporate rate regardless of the type of business conducted. This removes the ability for companies to gain from changing the apportionment of expenses to different types of business.

In relation to the apportionment of expenses between participating and non-participating businesses, the Life Insurance Act 1995 provides for statutory approval for the apportionments from both the appointed actuary and the external auditor, with a strong requirement to act in the best interests of policyholders. We understand that this is consistent with the current APRA practice relating to banks. Accordingly, we submit that Treasury should incorporate the use of the statutory expense apportionment for tax purposes.

Date of Commencement of the New Tax Regime

Lend Lease/MLC believes there are strong grounds for the date of commencement of the proposed tax changes for life companies to be deferred, by 12 months to, 1 July 2001. For life companies to properly carry out their fiduciary responsibilities to policyholders, implementation of the proposed reforms would require:

- re-education of customer service staff, sales forces and financial planners;
- policyholder communication strategies and programmes; and
- a major overhaul of policyholder administration and accounting systems.

The proposed changes represent the most substantial reform of life insurance taxation since 1 July 1988. Furthermore, the upgrading of systems necessary for implementation are in addition to the systems and other changes which will be required to implement a GST. We would strongly counsel against introducing both changes at the same time and instead recommend the deferral of the introduction of the income tax proposals for a period of 12 months, i.e. until 1 July 2001.

Offer to Meet Lend Lease/MLC Executives

Given the detailed technical nature of our submission and the attachments, we would appreciate it if senior executives of Lend Lease/MLC were able to meet with you and discuss the matters raised in the submission.

In summary:

- Lend Lease/MLC accepts tax on shareholders of life companies on a consistent basis with that of other business entities, subject to reasonable transitional arrangements.
- Taxation of policyholders should be imposed in a competitively neutral fashion.
- Commencement of the new tax system should be deferred at least until 1 July 2001.

We trust that the above comments and attached submission are of assistance to the Review in formulating its recommendations to Government.

Yours sincerely

David Higgins
Group Chief Executive
Lend Lease Corporation

Peter Scott
Chief Executive
MLC Limited

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TAXATION OF LIFE INSURANCE

INTRODUCTION

Life insurance companies underwrite policy contracts providing benefits to, or in respect of, individuals on death, disablement and critical illness (Risk Policies). They also underwrite policies providing investment returns – either guaranteed or linked to the performance of specified investment funds or through participation in profits– payable on death or survivorship to a specified date including in the form of annuity payments (Investment Policies).

Policy contracts may be written providing both investment and risk benefits in bundled form – e.g. whole of life and endowment assurance (Bundled Policies).

To the extent that investment returns are included, a life policy provides the owner with the opportunity to benefit from collective investment. In the interests of competitive neutrality, and consistent with our previous submissions, we seek taxation of policyholders benchmarked against the basis of taxation of direct investors and those investing in other Collective Investment Vehicles (CIVs).

REVIEW OF BUSINESS TAXATION (RBT)

The RBT paper ***A Platform for Consultation*** builds on the framework for taxing life companies as Business Entities under the Business Entity Tax Regime proposed in the Government's August 1998 paper ***A New Tax System***.

A Platform for Consultation addresses many of the concerns of the industry's participants, which would be raised as a result of the transition to the proposed regime. The Review recognised that it was necessary to consider technical matters in some depth. The length and complexity of our submission has therefore been necessary in order that we respond appropriately to these matters.

CONTENTS OF SUBMISSION

EXECUTIVE SUMMARY

We note that the RBT proposes a number of changes to company taxation.

We accept that, in relation to shareholder profits, life companies should be taxed in a similar way to other corporate bodies and business entities generally.

However, there are many aspects of the Review which we believe, if implemented, would have a seriously detrimental effect on policyholders. There is also every likelihood that the behavioural responses of companies, policyholders and their advisers would cause significant disruption to the industry for no net gain to Revenue. Accordingly Lend Lease/MLC believes there are strong grounds for reasonable transitional rules.

The Review, in ***A Strong Foundation***, commented that:

> "Economic transactions having the same economic substance should be taxed similarly, irrespective of their form."

Thus an objective of the tax reform proposals should be to achieve competitive neutrality for investors regardless of whether they invest directly, or through CIVs such as life policies or unit trusts. Not only is this approach clearly fair and reasonable, but to do otherwise would favour wealthy investors against the less wealthy. Wealthy investors can obtain the risk reducing benefits of diversification of investments by investing directly. However, the high individual minimum amounts often required for each investment can often mean that less wealthy investors can only obtain such diversification through CIVs such as life policies.

For life companies to properly carry out their fiduciary responsibilities to policyholders, implementation of the proposed reforms would require:

- re-education of customer service staff, sales forces and financial planners;
- policyholder communication strategies and programmes; and
- a major overhaul of policyholder administration and accounting systems.

For these reasons Lend Lease/MLC believes that commencement of the new tax system should be deferred by 12 months until 1 July 2001.

In summary:

- Lend Lease/MLC accepts tax on shareholders of life companies on a consistent basis with that of other business entities, subject to reasonable transitional arrangements.
- Taxation of policyholders should be imposed in a competitively neutral fashion.
- Commencement of the new tax system should be deferred by 12 months, i.e. until 1 July 2001.

Policyholders

	Recommendation	Reason
1.	Policyholders' investment returns under superannuation policies should be excluded from the Business Entity Tax Regime. (Page 7) This recommendation also applies to Rollover Deferred Annuities. (Page 18)	Life company superannuation policies are simply another form of superannuation fund investment; they should remain on the current 15% tax paid basis to preserve competitive neutrality with "stand alone" funds including Industry Funds. Rollover Deferred annuities are also simply another form of superannuation investment.
2.	We support the Review's proposal that investment returns from Ordinary policies should ultimately be subject to tax at the policyholder's marginal rate. (Page 9)	This is consistent with the taxation of returns to individuals from direct investments and other collective investment vehicles (CIVs).
3.	We support the Review's suggestion that life companies be given the opportunity to issue two types of Ordinary investment (or bundled) policy – one where "bonuses" are assigned on termination, and the other where "bonuses" are assigned annually. (Page 9)	(i) Assignment of bonuses on termination maintains the current position for life policies where the policyholder is assessed for tax on termination. (ii) Policyholders with annual bonuses can be assessed for tax on an equivalent basis to other CIVs.
4.	Taxable income should exclude unrealised gains, allow indexation of realised gains and allow the flow through of tax preferred income to the extent this is to continue. (Page 27)	Life company income attributable to policyholders should be assessed for tax as far as possible on the same basis as applies to individuals.
5.	In assessing policyholder tax, existing policies should be fully "grandfathered" under the existing regime (Option 1). However, existing policyholders should not be given an opportunity to elect to treat an existing policy as a new policy. (Page 16)	(i) This approach maintains policyholders' expectations which were set at the time of commencement of the policies. (ii) It avoids confusing existing policyholders. (iii) There need be no change to administration systems for existing policies. (iv) The suggested "New Policy" election is not needed as policyholders' expectations are maintained.

	Recommendation	Reason
6.	All investment related fees and charges which are included in premiums or deducted from investment income or policy benefits should be treated equally – as a deduction by way of reduction in the investment return to policyholders. (Page 14)	(i) All such fees and charges will be subject to tax in the hands of the shareholders. (ii) The approach is equitable, simple, and is easily understood.
7.	Interest payable on borrowings to fund the investment component of premiums under Ordinary policies with bonuses, whether annual or terminal, should be deductible from the policyholder's taxable income. (Page 8)	This would ensure consistency with the deductibility of interest on borrowings for investment in CIVs.
8.	"Averaging" in the same manner as for assessment of capital gains tax, should be applied in the assessment of tax on policy proceeds in the hands of policyholders. (Page 11)	As for capital gains, the income accruing under a life policy may be earned over a period of years, rather than only in one year. It is the individual's marginal rate of tax applicable to the <u>average</u> yearly income that should apply, rather than the marginal rate caused by receiving the whole amount in one year.
9.	We support the Review's suggestion that policyholder income under immediate annuities (including allocated annuities) be exempt from tax. (Page 27)	This is consistent with the current arrangements for such policies and is an integral part of the existing superannuation and retirement income framework.
10.	Commencement of the new tax system should be deferred by 12 months to 1 July 2001. (Page 12)	For life companies to properly carry out their fiduciary responsibilities to policyholders, implementation of the proposed reforms would require: • re-education of customer service staff, sales forces and financial planners; • policyholder communication strategies and programmes; and • a major overhaul of policyholder administration and accounting systems.

Shareholders

	Recommendation	Reason
1.	Taxable Income should be determined using the approach set out in Option 1, subject to modification to ensure that: • Tax is not levied on unrealised gains, • fees deductible from policyholders' returns are not double counted in the calculation of life company income, • concessional rates of tax are levied on income attributable to policyholders eligible for such concessions, • the increase in policyholders' liabilities includes current and deferred taxation attributable to policyholders. (Page 21)	(i) The modified Option 1 approach can readily be applied to **all** of a life company's business and is consistent with the Review's objective of simplicity. (ii) The approach is similar to that currently applicable to RSA's. The effect is for: - Policyholders to be taxed on income allocated to their policies; and - Shareholders to be taxed on **all** other income including fees. (iii) Option 1 corresponds to the method currently used for Accident and Disability Business and RSAs, and for General Insurers. It is considered to be more robust than Option 2. (iv) The Option 1 approach can produce a similar outcome for Immediate Annuities as that suggested in the paper. (v) Adjustments for unrealised gains and indexation of gains are required for consistency with the taxation of individuals and other CIVs.
2.	The increase in "actuarial liabilities" allowed as an outlay item in the determination of taxable income in the Option 1 formula, should be based on the Solvency Requirement for the policies. (Page 25)	The Solvency Requirement for the policies effectively represents their current termination values together with prudential margins. As such, it corresponds with the value of liabilities adopted in the determination of tax for General Insurers, and, for Life Insurers, it reflects the current approach adopted for the taxation of Accident and Disability Business. The Solvency Requirement is published in Financial Statements, and is calculated on a prescribed basis.

	Recommendation	Reason
3.	The significant increase in taxation anticipated under the proposals should be phased in over a period of years, through appropriate transitional arrangements. (Page 19)	(i) It is reasonable (and not unusual) for a major change in taxation applied to an industry, to be phased in over a period of years, to avoid disruption to the industry. (ii) Writing life insurance business involves significant costs. Relief for such costs in relation to existing business has been given at an average rate of 20%. The income to repay those costs arises from future margins in the policies. Application of a 36% tax rate to such income has the effect of imposing additional tax in an arguably retrospective manner. (iii) In some instances life companies will adjust the pricing of their policy contracts and effectively pass on some part of the increased tax cost to policyholders. This "flow-on" to policyholders will occur so as to support shareholders return on equity requirements.

Taxation Framework for Policyholders

Investment Returns

RBT Proposals

Policyholders should be subject to their personal rates of tax on their investment returns from the policies. This includes trustees of superannuation funds being taxed at 15% on their investment returns under Superannuation policies.

Tax would be levied at the corporate rate (currently 36%, but under review) on investment returns in the hands of the life company. Policyholders would include investment returns from life policies in their tax returns and receive refundable imputation credits against their personal tax assessment. This will depend upon the type of policy involved. In general, for Superannuation business the tax rate would be 15%, and for Ordinary business the individual's marginal tax rate would apply. Refunds would be available for tax overpaid at the life company level.

Exceptions to this procedure would be Retirement Savings Accounts, Deferred Annuities and Immediate Annuities, where the tax levied in the life company would (continue to) be 15%, 15% and 0% respectively.

Submission

In general, the proposals put Ordinary policies on a similar footing with other CIVs, and are supported.

We are concerned, however, over the proposed treatment of Superannuation policies. These comprise 80% of the business of life companies, with funds under management of $123b at 30 June 1998. It is necessary for the current 15% tax paid regime to continue in life companies in order to maintain competitive neutrality with other superannuation investment vehicles. These issues are covered more fully in our first submission on the taxation of superannuation investment vehicles, forwarded to the Review on 29 March 1999.

Relief for Fees/Costs

RBT Proposals

Fees are levied and costs are charged to policyholders in a wide variety of ways – some explicit, some incorporated in the contract through reduction in benefits. Various forms of relief for policyholders are proposed, depending on the type of fee or cost.

Submission

We submit that the different approaches proposed add complexity to the system.

We note that it is intended to tax the shareholder on <u>all</u> fee income, from whatever source, and however imposed.

We suggest therefore that <u>all</u> investment related fees and charges, which are included in premiums or deducted from investment income or benefits, be treated as reductions in the investment return to policyholders.

Fees that are paid <u>in addition to</u> the premium should be treated, as proposed, as related to an investment of capital. They should then be deductible in the hands of the policyholder on a consistent basis with investments in other CIVs.

More detailed comment, is included in the section "Treatment of Policy Fees" (Page 14).

Risk Benefits and Premiums

RBT Proposals

No tax would be paid by policyholders on the benefits arising from pure risk insurance policies– whether through death, disablement or critical illness – except where tax relief had been provided for the premiums paid.

Premiums would be deductible from taxable income if they can be justified as expenses incurred in the obtaining of income.

The general approach for Bundled Policies is to ensure that a similar position arises in respect of the part of such policies related to risk benefits and premiums.

Submission

The proposals follow current practice and are supported.

Interest Deduction on Borrowing

RBT Proposals

The Review is silent on this subject.

Submission

Section 67AAA of the Income Tax Assessment Act denies a deduction in respect of interest on borrowing where the amount borrowed has been invested as premiums for life policies.

Interest deductibility has been denied since August 1992 – essentially on the grounds that life policies do not provide an annual assessable income.

We submit that new style policies, where an amount is assessable to the policyholder, either annually or on termination, should now permit financing costs to be immediately deductible. This treatment would then be consistent with the deductibility of financing costs generally and with the taxation treatment available to investors who borrow to invest in other CIVs.

NEW ORDINARY (NON SUPERANNUATION) POLICIES

RBT Proposals

It is proposed that holders of ordinary policies pay tax at their marginal rates on their investment return under the policies (i.e. bonuses assigned), with allowance for imputation credits reflecting tax paid by the life company on behalf of policyholders.

Submission

We support this proposal as this would make the taxation of investment returns to policyholders consistent with the taxation of investment returns to individuals who invest directly or in other CIVs.

Options

RBT Proposals

Three options for the calculation of the policyholder's tax are proposed:-

Option 1 **–** Calculate and pay net tax each year or when bonuses are received;

Option 2 **–** Calculate the tax shortfall every year and pay net tax at that time or when bonuses are received; and

Option 3 **–** Calculate and pay net tax when bonuses are assigned.

It is also proposed that, under Options 1 and 2, policyholders may be given the opportunity to choose when they should be assessed for the tax.

We note with interest that the Review has proposed that life companies be given the opportunity to issue two types of policy – one where bonuses are assigned only on termination, and the other where bonuses are assigned annually.

Submission

Policyholder Choice

We have recognised that giving policyholders choice is of advantage to them. However, the administration of such arrangements can become difficult – particularly where it is possible for the election to be varied a number of times, and at any time, during the term of the policy.

We therefore submit that the policyholder's election should be focused simply on the type of policy selected at commencement, rather than under an option within the policy.

On this basis we support the Review's proposal of allowing two types of policy. For these, we would suggest:-

(1) Bonuses assigned only on termination, with taxation assessed at that time at the policyholder's then marginal rate (Option 3), but subject to "averaging" (refer Page 11).

(2) Bonuses assigned annually in respect of investment income received including realised capital gains (indexed), and assessed annually (Option 1), together with a bonus assigned on termination with taxation assessed at that time at the policyholder's then marginal tax rate.

Unrealised Gains

Currently, revenue and capital gains are taxed only on realisation.

A Platform for Consultation suggests in various places that a consequence of particular proposals could be for tax to be levied on unrealised gains.

We strongly object to any situation where a life company, or a policyholder should be subject to tax on gains when no proceeds have been received. To do so would amount to a significant competitive disadvantage relative to other investment alternatives.

We submit therefore that, in the case of the annual assignment of bonuses, taxation should be assessed only on realised gains.

Indexation of Capital Gains

For Ordinary business, no indexation of gains has been allowed - on the basis that the life company holds investments for the purposes of trading.

We submit that the turnover of life companies' investments is no greater than that of CIVs – where a capital gains component is passed on to the investors.

In any case, the benchmark should be the treatment of gains in the hands of an individual.

The competitive neutrality benchmark demands that, if indexation continues to be available to individuals, then it should also be available where such individuals invest in CIVs – such as life policies as well as unit trusts.

Capital Gains Treatment

The Review proposes the possibility of changes to the taxation of capital gains in the hands of individuals and superannuation funds. We submit that, for consistency and competitive neutrality, any changes made to the treatment of capital gains, the benefit of which can flow through CIVs to individual investors, should also be available to Ordinary policyholders.

Investment Income Components

The investment income attributable to policyholders will usually comprise a mix of components with different taxation characteristics. These include interest from fixed interest investments and property rents, with no tax deducted at source, Australian share dividends with imputation credits, foreign investment income net of withholding tax, tax preferred income from property enjoying the benefit of accelerated depreciation allowances, and capital gains, both unrealised and realised, some of which may have the benefit of indexation.

It is important that policyholders are taxed on each of these components in a manner consistent with their taxation as if they were investing directly in similar investments as individuals. This approach applies to the taxation of income for other CIVs.

A life company should be required to identify the separate components of income in policyholder statements. These would also show imputation credits given, and be the basis for the policyholder's tax assessment on bonuses assigned.

While this would require development of suitable systems by life companies, the technology and software is already available as such information is required for unit trust and other fund management operations.

Averaging

The income assessed for tax in the policyholder's hands following termination of a policy will usually have arisen over a period of years.

This corresponds to the realisation of a capital gain which may also have arisen over a long period.

"Averaging" relief is given for capital gains – whereby the individual's marginal tax rate is determined as that applicable to the average yearly gain.

It is recommended that such "averaging" is applied also to the income assessed on termination of a life policy, averaged over the period since its commencement.

Participating Policies

Participating policies include mainly whole of life insurance, endowment insurance, pure endowment and investment account policies. Many of these are Bundled Policies.

RBT Proposals

In principle, the taxation of participating policies is intended to be no different from that of other policies.

For new policies, policyholders would be assessed for tax at their marginal rates on the excess of the policy proceeds (PP) over the investment component of premiums paid (IP). Imputation credits would be available to the policyholder in respect of tax paid by the life company.

Submission

It is noted that the policy proceeds will effectively be those available after charges have been levied or incurred during the life of the policy for the cost of any risk cover – death, disablement or critical illness.

In order for (PP – IP) to reflect purely the investment return allocated to the policy, it is necessary for the deduction from total premiums for the cost of risk cover to equal that cost effectively deducted in arriving at the amount of the policy proceeds.

For participating business, this is determined from the actual experience of the fund. However, allocating this cost of risk cover appropriately to each policy would be a very complex exercise. It is proposed therefore to adopt the best estimate assumptions made by the appointed actuary for the purposes of determining the Policy Liabilities for the Financial Statements for each of the relevant years.

Thus the investment component of the premium payable in any year is equal to:-

Total Premium – Cost of Risk Cover

when the Cost of Risk Cover = q x (sum insured – CTV) where q is the cost per unit of risk for one year and CTV is the Current Termination Value.

This appears to be an elaborate procedure. However, the data should be readily available to enable the calculation to be carried out each year.

Moreover, this approach will be consistent with the method outlined in this submission for calculating the policyholders' share of taxable investment income (net of fees) in the determination of the life company's taxable income.

Date of Commencement of New Tax Regime

RBT Proposals

The proposed date of commencement is the beginning of the first financial reporting period ending after 1 July 2000.

Submission

The proposed tax changes are significant and complex. The new tax regime demands the following significant upgrading to policy administration and accounting systems to accommodate the new style policies envisaged:

(a) Policyholder franking credit accounts

(b) Annual assignment and advice of bonuses

(c) Imputation credit advices to policyholders – annually for some policies.

In addition to the work required to make the necessary above changes, life companies will be required to carry out:

(1) extensive training of staff, agents and financial planners; and

(2) a carefully constructed communication plan for policyholders.

The proposed changes are the most substantial reform of life insurance taxation since 1 July 1988. Furthermore, the system changes required for implementation are in addition to the systems and other changes which will be required to implement a GST.

We would strongly counsel against introducing both changes at the same time, and instead recommend deferral of the introduction of the income tax proposals for a period of 12 months, i.e. to 1 July 2001.

TREATMENT OF POLICY FEES

RBT Proposals

The basic structure proposed is:-

(a) Shareholders are taxed on fee income.

(b) Policyholders may receive tax relief on fees paid – either directly by claiming against personal tax, or implicitly as a result of deduction from policy benefits.

Submission

The Review proposes that policyholders pay tax when bonuses are assigned to their policy. Options have been suggested as to when this may occur (i.e. either annually or termination) and how the amount would be determined.

In this submission we have recommended that two forms of Ordinary policy be acceptable:-

(1) where bonuses are only assigned on termination of the policy, and

(2) where bonuses are assigned annually in respect of investment income received, including realised capital gains, with a final bonus on termination.

In each case, it is submitted that the policyholder's taxable income would be calculated after ***allowing a deduction for all fees*** included in premiums or deducted from investment income or policy benefits.

In (1), the policyholder taxable income on termination would equal

(a) "total policy proceeds, less

(b) the investment component of premiums paid" (including any fees incorporated in the premiums).

In (2), the annual bonus would be calculated after allowing for annual fees, other than premium based fees. The final bonus on termination would be the same as in (1) above.

Effect of Submission Suggestions

The effect of the above proposals will be:-

(a) where bonuses are assigned on termination - to give the policyholder the benefit of tax relief for fees paid over the policy term, at termination, at the policyholder's then marginal rate of tax,

(b) where bonuses are assigned annually - to give the policyholder annual tax relief on annual fees paid, with tax relief on premiums only available on termination – again at the policyholder's marginal rate of tax.

The paper proposes that premium based fees should be treated as being capable of offset against "capital gains", i.e. when the life policy investment is terminated. This is consistent with the treatment of fees charged to unit trust investors where the fee forms part of the cost base of the investment.

This will effectively apply in terms of the policyholder's own assessment for tax under both types of policy envisaged above.

EXISTING POLICIES

RBT Proposals

The general approach in the paper is to recognise existing policyholder expectations as regards the "10 year" rule. Consideration is then given to a range of possible transitional arrangements.

Options

Three options are suggested for industry comment. These are described as:-

Option 1 – Continue to apply the current taxation treatment to bonuses paid on existing life insurance investment policies;

Option 2 – Apply the redesigned imputation system to bonuses paid on existing life insurance investment policies terminated within 10 years (from their commencement), and the current taxation treatment to bonuses paid on existing policies terminated after 10 years; and

Option 3 – Apply the redesigned imputation system to bonuses paid on all existing life insurance investment policies. The rate of tax on bonuses paid on existing policies terminated after 10 years would be capped at the company tax rate.

Submission

Lend Lease/MLC supports Option 1 as the approach which is least likely to negatively affect policyholders.

Policyholder Election

In para 35.61, it is suggested that "it would be logical to allow policyholders to elect to treat an existing life insurance investment policy as a new life insurance investment policy. That would mean that policyholders would not face unnecessary transaction costs."

In our view, existing policyholders have entered into their policies on a certain tax basis, and arguably, the policyholders have expectations that their tax treatment will be maintained.

To provide **all** policyholders with sufficient material to enable them to make a decision, would be an onerous exercise. Even if we adopted a fall back position of "no change" in the event of failure to reply, we would still be inundated with enquires from many people for whom the "treatment as a new policy" would be of no benefit. For such policyholders the process would represent a huge waste of time, and may upset many of our older policyholders.

Moreover, it is proposed that the definition of "bonuses" would change under the proposed system. It would not be the whole of the premiums paid that are deducted from the policy proceeds as at present. It would only be the "investment component" of such premiums.

To "convert" an existing policy to a new policy would involve retrospective identification of the investment component of all premiums paid prior to the introduction of the new tax system.

Attempting to track such components historically would be a very elaborate and costly process and require system support.

We are therefore strongly of the view that no existing policyholder should be given the option to elect to have an existing policy treated as a new policy.

Conversion to New Policies

It will, of course, be open to any policyholder to surrender an existing policy, or make it paid up, and effect a new one. Companies may, of their own accord, choose to offer favourable terms in such circumstances.

“rollOver” deferred annuities

RBT Proposals

The paper (paragraphs 34.65 to 34.71):-

(i) proposes that existing policyholders should continue to have investment income under rollover deferred annuities taxed at 15% in the same manner as other superannuation business,

(ii) notes that the existing procedures do not appear to fit readily with the proposed taxation of life companies under the Business Entity Tax Regime, and

(iii) suggests various methods under which the principle in (i) above could be achieved - one of those methods being that the deferred annuity business would need to be moved out of the life company.

Submission

We see no purpose being served by making any changes to the existing regime. Rollover deferred annuities are simply another form of superannuation investment.

The taxation procedures for these products are well established and controlled. There is a good understanding of the nature of the product in the community.

The calculation of taxable income of the life company in respect of (concessionally taxed) deferred annuity business is accommodated under Option 1 (section 34.22), with the modifications suggested in this submission. This will ensure that shareholders pay tax at the corporate rate on all investment income and profits, other than that which has been allocated to policyholders which would continue to be taxed at 15%.

In the circumstances, we see no need to withdraw the current tax treatment for either new policies or existing policies. In any case the paper’s suggestion that existing business be transferred to RSA’s, complying superannuation funds or ADF’s, is impractical. The policies are contracts owned by individuals who would need to be parties to any changes in the terms of their policies.

Taxation Framework for Shareholders

RBT Proposals

The aim of the proposals is to levy tax at the corporate rate on the whole of a life company's:-

(i) investment income, plus

(ii) fee income, less

(iii) deductible expenses, plus

(iv) underwriting profits.

The major part of most companies' investment income is attributable to policyholders. Policy benefits would be reduced by the tax on such income, which would be effectively retained by the shareholders for inclusion in the total tax assessment for the company.

Accordingly, the shareholders would effectively bear tax on their own account at the corporate rate on:-

(1) total investment income, less income attributed to policyholders, plus

(2) fee income, less

(3) deductible expenses, plus

(4) underwriting profits.

Submission

We support this framework.

Proposed Transitional Arrangements

Currently, the industry wide tax rate effectively paid by shareholders on their part of life companies' taxable income is, on average, around 20%.

It is submitted that an immediate or single step increase to 36% (or even 30%) would cause significant disruption to the industry. The profitability of many existing policies, written under current rules, will reduce – possibly to a negative position. This may require the injection of additional capital.

The writing of life insurance business involves significant up front costs. Relief for such costs in relation to existing business has been given at an average rate of 20%. The income to repay those costs arises from future margins embedded in the policies. Application of a 30% or 36% tax rate to such income has the effect of imposing additional tax in an arguably retrospective manner.

In some instances life companies will be able to adjust the pricing of their policy contracts and effectively pass on some part of this increased tax cost to policyholders. The "flow-on" to policyholders will occur so as to support shareholders' return on equity requirements.

In other cases such adjustments will not be possible. That business may well become loss making because:-

- the initial tax advantage has already been, to some extent, priced away to policyholders, and
- the increased tax would not be recoverable from policyholders.

Finally, the tax rate adjustment itself from, on average 20% to either 30% or 36% is significant. In other instances, where significant tax rate changes have been introduced, most notably in the case of credit unions and friendly societies, those changes have been "phased in".

Lend Lease/MLC believes that, in view of the above factors, there are strong grounds for reasonable transitional rules for the tax rate increases that have been proposed.

life company Taxable Income

RBT Proposals

The paper proposes that a life company be taxed an amount which incorporates both the tax on shareholders' income, and the tax on policyholders' income (subject to certain exemptions), calculated at the corporate rate.

Options

Three options for the determination of taxable income are proposed. These are referred to in the paper as:-

Option 1 – "Include Premiums in Assessable Income"

Option 2 – "Identify Components of Taxable Income"

Option 3 – "A combination of Option 1 and Option 2 under which:

(a) Risk Business taxable income would be calculated using Option 1, and

(b) Investment Business taxable income would be calculated using Option 2".

All three options are intended to produce similar results, and include the liability for policyholder tax. The choice to be made is essentially based on administrative ease of calculation, the monitoring of the calculation, its robustness and minimising opportunities for manipulation.

Policyholder Tax

The paper recognises the need to make special allowance for types of business where policyholders should be taxed at a lower rate than the corporate rate. These include immediate annuities and deferred annuities, and by implication, RSA's.

In this submission, we have recommended that policyholder benefits under Superannuation policies also be excluded from the Business Entity Tax Regime.

Submission

We support the adoption of Option 1, in principle, subject to certain modifications outlined below, as it appears closest to focusing on taxing shareholders on the underlying earned and distributable profits of life companies.

The modifications suggested below are those necessary to ensure that it is distributable profits which are taxed, to recognise where policyholders' tax is applied at a different rate from that for the shareholders, and to ensure consistent taxation principles apply as between the shareholders of life companies and those of other business entities.

Advantages of Option 1

Some advantages of Option 1 are set out in the paper. To these can be added:

- The approach can readily be applied to **all** of a life company's business and is consistent with the Review's objective of simplicity.

- The approach is similar to that currently applicable to RSA's. The effect is for:
  - Policyholders to be taxed on income allocated to their policies; and
  - Shareholders to be taxed on **all** other income including fees.

- Option 1 corresponds to the method currently used for Accident and Disability Business and RSAs, and for General Insurers. It is considered to be more robust than Option 2.

- The Option 1 approach can produce a similar outcome for Immediate Annuities (including Allocated Annuities) as that suggested in the paper.

Modification – Avoid Double Counting of Fee Income

Option 1 may be expressed as requiring the taxable income of the company (TI) to equal Premiums (P) + Management Fees (F) + Investment Income and other income (I) – Expenses (E) – Policy Claims (C) – [Increase in the value of Policy Liabilities (ΔL) - Policyholders Taxable Income (PTI)], i.e.

$$TI = P + F + I - E - C - \Delta L + PTI$$

To determine these items in a robust manner, it is desirable to utilise numbers from statutory returns as far as possible. These amounts are subject to independent audit as well as actuarial certification under the Life Insurance Act 1995.

For this purpose, it would be usual for the fees described as Management Fees in the paper to be deducted from the Policyholder "account balances" – whether under an investment linked policy or an investment account policy. Thus the increase in the policy liabilities, (ΔL) in the formula, is an amount determined <u>after</u> the deduction of these Management Fees.

In other words, to include management fees at both the item (F) in the formula and in (ΔL), would effectively "double count" such fees in determining Shareholders' Taxable Income.

This is illustrated in the following example which examines the revenue accounts of the separate Policyholders' and Shareholders' Interest in the Statutory Fund for investment linked business:-

(Please note that, for simplicity, we have assumed (and are recommending) that <u>all</u> fees taxable in the shareholders' hands should be deductible in determining the policyholders' taxable income within the life company.)

	Statutory Fund	**Policyholders "Accounts"**	**Shareholders' Interest**
Premiums (P)	1000	1000	-
Investment Income (I)	550	500 (PI)	50 (SI)
Fees (F)	-	(100) (F)	100 (F)
Expenses (E)	(80)	-	(80)
Claims (C)	(200)	(200)	-
Increase in Policy Liabilities (ΔL)	(1200)	(1200)	-
"Profit"	70	-	70

Shareholders Taxable Income + Policyholders Taxable Income

i.e. (Fees + Shareholders' Investment Income less Expenses) + (Policyholders Investment Income less Fees)

i.e. TI = (F + SI – E) + (PI – F). This reduces to SI + PI – E

= <u>I – E</u>

i.e. Total Investment Income less Expenses

In the above example this is 550 – 80 = 470,

made up of (100 + 50 – 80) = 70 for Shareholders,

and (500 – 100) = 400 for Policyholders.

Now the Increase in Policy Liabilities ΔL = Premium (P) + Policyholders Income (PI) – Fees (F) – Claims (C)

i.e. $\Delta L = P + PI - F - C$

Substituting for ΔL in the formula for TI at the top of the previous page, we have

$$\begin{aligned} TI &= P + F + I - E - C - [P + PI - F - C] + PTI \\ &= 2F + I - PI - E + (PI - F) \\ &= \underline{\mathbf{F + I - E}} \end{aligned}$$

This compares with the intended total of **<u>I – E</u>,** which has already counted "F" as taxable in the shareholders' hands and deductible for policyholders.

Thus the item "F" should be excluded from the formula.

This illustration also serves to show that, under the existing I – E tax base, shareholder profits are effectively already being taxed, albeit at the rate of tax applicable to the statutory fund. For Superannuation business that is at 15%, for Annuity business that is at 0% and for Ordinary business at 39%. We understand that the "blended rate" for the industry as a whole is, on average, about 20%.

Modification – Ensure Inclusion of Policyholders' Current Taxation

It is noted that the increase in Policyholders Liabilities (ΔL) will have been reduced by the amount of current taxation attributable to policyholders (PT). This will need to be added back for the purpose of determining the increase in policy liabilities deduction in the formula.

Accordingly, taking account of the above two adjustments, we suggest that the formula be restated:-

$$TI = P + I - E - C - (\Delta L + PT) + PTI$$

where "I" is investment income plus all other income which does not correspond with amounts which have been debited to policyholders' accounts.

Modification - Accommodate Shareholders'/Policyholders' Different Tax Rates

The above formula may be said to equal the sum of:-

(i) Shareholders' Taxable Income (STI) = $P + I - E - C - (\Delta L + PT)$, and

(ii) Policyholders' Taxable Income (PTI) = Policyholders Investment Income (PI) less Fees (F)

The Shareholders' Taxable Income will be subject to tax at the corporate rate, and the Policyholders' Taxable Income will be subject to the appropriate rate depending on the class of business.

This is equivalent to the basis which currently applies to the determination of taxable income for RSA's.

Risk Business

Under Risk Business there is no policyholder tax. Accordingly, PT and PTI are zero. The effect is for all investment income to be taxed in the hands of the shareholders.

Option 1 then corresponds with the regime currently applicable to the Accident and Disability business of Life Insurers, and all the business of General Insurers.

Disadvantages of Option 1 – Calculation of Actuarial Liabilities

The paper drew attention to the possible disadvantage of Option 1 arising from the need to rely on the calculation of actuarial liabilities, and the need to make suitable assumptions for that calculation. Some limitations of the statutory "Margin on Services" calculation of policy liabilities were identified.

Use of Solvency Requirement for the Policies (SRP) as "Actuarial Liabilities"

We submit that adoption of the Solvency Requirement for the policies (SRP) should eliminate these concerns.

The Solvency Requirement is the amount of assets required to meet the statutory Solvency Standard. The basis of calculation is prescribed by the Life Insurance Actuarial Standards Board in its standard AS2.01. This leaves negligible room for uncertainty with regard to the calculation, or for manipulation.

One component of the Solvency Requirement is the value placed on non policy liabilities. Accordingly, this should be deducted to arrive at the Solvency Requirement for the policies (SRP) for tax purposes.

SRP effectively represents the current termination values of the policies together with prudential margins. As such, it corresponds with the value of liabilities adopted in the determination of tax for General Insurers, and, for Life Insurers, it reflects the current approach adopted for the taxation of Accident and Disability Business.

We submit therefore, that the use of the Solvency Requirement for the policies, as calculated for statutory purposes, as the "actuarial liabilities", is particularly suitable for the purpose of determining a life company's taxable income.

SRP Prudential Margins

The prudential margins in SRP will be represented by Shareholders' Capital and Shareholders' Retained Profits, (and for some types of business, Policyholders' Retained Profits – mainly participating business).

However, the Option 1 formula, modified as suggested, will still levy shareholder tax at the corporate rate on **all** the income from **all** the assets of the fund or subfund, excluding the income which has been allocated to policyholders.

The existence of the prudential margins in the "Actuarial Liabilities" only serves to defer taxation until the policies are terminated. Relief is effectively given on the prudential margins when business is written; tax is payable on the release of the prudential margins when policies go off the books. In our view this treatment is justified since such amounts are neither earned nor distributable until that time.

This is demonstrated in the following simplified example of a portfolio of two year term risk insurance policies. Investment income will be small, and will be the same under each scenario (assuming Retained Profits at the start of the policies of at least 20 to cover the Year 1 "loss" after providing the prudential margins).

	Liabilities without Prudential Margins			**Liabilities with Prudential Margins**		
	Year 1	**Year 2**	**Total**	**Year 1**	**Year 2**	**Total**
Premiums	50	50	100	50	50	100
Expenses	(30)	(10)	(40)	(30)	(10)	(40)
Policy Claims	(15)	(30)	(45)	(15)	(30)	(45)
Increase in Liabilities	(20)	20*	-	(25)	25*	-
"Profit"	(15)	30	**15**	(20)	35	**15**
Tax Relief (Tax) at 36%	5.4	(10.8)	**(5.4)**	7.2	(12.6)	**(5.4)**

* Release of Liabilities as policies go off the books.

There will be a further minor, but important issue, to be addressed. As policies go off the books after the new tax regime has commenced, the prudential margins related to those policies will be released and fall into taxable income. This implies relief would have been given when the prudential margins were established. This would not have been the case prior to the commencement of the new tax system (except perhaps in the case of Accident and Disability business where prudential margins have been included under the current tax regime).

Accordingly, at the start date of the new tax regime (proposed 1 July 2000, but recommended 1 July 2001) it will be necessary for life companies to be given tax relief in respect of the prudential margins existing at that date.

Other Disadvantages of Option 1

Other disadvantages noted in the paper comprise essentially:-

(i) the need to exclude (policyholders') investment income from the change in actuarial liabilities, and

(ii) identifying adjustments to avoid duplication of income or deductions in the calculation of taxable income may be difficult.

With regard to (i), the suggested adjustment to the formula indicates that policyholder income must be calculated as it forms the basis of the calculation for taxation attributable to policyholders, and so will be readily available.

With regard to (ii), some modifications are suggested in the following paragraphs to the Option 1 formula and calculation procedure. These, together with the recommended alignment of assessibility and deductibility of fees, reduce the difficulty in identifying adjustments to avoid duplication of income or deductions in the calculation of taxable income.

RSA's, Deferred Annuities, Superannuation Business

Under the proposals in the paper, the business of RSAs and Immediate Annuities would be "quarantined" in such a way as to ensure that the investment income attributable to the policyholders was taxed only at 15% and 0% respectively. We are proposing that this approach also applies to Superannuation business, including Deferred Annuities.

The Option 1 formula, adjusted as suggested, in conjunction with the use of the Solvency Requirement for the policies as the actuarial liabilities, operates appropriately for the purpose of determination of taxable income for this business.

Immediate Annuities (Including Allocated Annuities)

The paper (paragraphs 34.43 to 34.57) recommends that the interest component in an annuity, or credited to an allocated annuitant's account, should be a deduction in determining taxable income. Effectively, this means that the income attributed to the Policyholders would be exempt from tax in the life company's hands. This is supported as being consistent with the current arrangements for such policies. It is also an integral part of the existing superannuation and retirement income framework.

Life company accounting demands a "mark to market" approach in the valuation of assets. Actuarial liability standards demand a corresponding adjustment to the value of policy liabilities.

Consequently investment income for annuity business will include gains or losses from the revaluation of assets.

The Option 1 approach to the determination of taxable income (with the modifications suggested) reproduces the basis of taxation set out in the paper for annuities. It also makes the necessary adjustments for the appropriate inclusion of gains in the determination of the investment income attributable to the annuitants to be deducted.

Unrealised Gains

Under the current tax regime, investment gains are only taxed on realisation. This is consistent with the well established principle of levying tax when the benefit is received. It also recognises that, until an investment is realised, cash is not available to pay tax on any gains.

The investment income (I) and the Policyholders income (PI) in the Option 1 formula cannot therefore be obtained directly from accounting entries for Financial Statements as these include (by virtue of statutory requirements) unrealised gains.

Suitable adjustment will therefore be required to these items to exclude unrealised gains arising during the financial year, i.e. ΔUGS and ΔUGP, for amounts attributable shareholders to policyholders respectively.

The Policy Liability will have been reduced by the increase in the deferred tax reserve attributable to policyholders, i.e. ΔDTRP. This should be added back for the purpose of determining the increase in Policy Liability deduction in the formula.

Revised Option 1 Formula

Allowing for the above adjustments, the Option 1 formula becomes:-

Total Taxable Income (TI) =

Shareholders Taxable Income (STI) = P + I – E – C – (ΔL + PT + ΔDTRP) - ΔUGS

plus Policyholders' Taxable Income (PI – F – ΔUGP)

Capital Gains

Under the current superannuation tax regime indexation applies in the calculation of the tax on capital gains. To the extent that this continues, it should also continue to apply to the Superannuation business of life companies.

Although capital gains tax does not currently apply in the determination of tax for Ordinary business, we submit that it should be adopted under the new regime for life companies for two reasons:

(1) Only one tax calculation would be required for all types of life company business. This addresses the complexities raised by the Review at paragraph 34.2 of the discussion paper. (At present, two tax

calculations are required for some assets adding significant complexity to the life company tax basis); and

(2) It is consistent with the tax basis applied by most competitor CIVs which recognise realised capital gains as a distinct component in distribution statements. If changes are made to the treatment of capital gains more broadly, the benefit of which can flow through CIVs to individual investors, then those benefits, in the interests of competitive neutrality should similarly be available to Ordinary policyholders.

This enables individual and superannuation investors to continue to obtain the same treatment as they would have had they invested directly, via CIVs or life policies.

Foreign Investment Income/Tax Preferred Income

Income received from investments in many foreign countries is subject to withholding tax. Under double taxation agreements between such countries and Australia, withholding taxes can be offset against Australian tax.

Investments in property in Australia can generate building and depreciation allowances, some of which are "accelerated" (i.e. the depreciation is written off over a shorter period than the expected lifetime of the investment).

To the extent that these preferences continue to be available to reduce the tax payable on income by individuals or stand alone superannuation funds, they should also be available to reduce the tax payable by policyholders. This should apply both in the determination of the tax payable by the life company on behalf of the policyholders, and in the policyholder's own tax assessment on bonuses assigned to the policy.

The application of a Deferred Company Tax ("DCT") or a Resident Dividend Withholding Tax ("RDWT") to life company bonuses would effectively undo the benefit of these tax preferences for policyholders.

Policyholders' Taxable Income

Policyholders' income will be that income which is allocated to the policyholders in terms of their policy contracts.

This income will be made up of interest, dividends and rents, and will include realised and unrealised gains and other components which are treated in different ways for tax purposes.

In order to assess tax in the life company on income attributable to policyholders correctly, it will be important to ensure that the components of such income and the assets giving rise to it are identified appropriately.

In some cases, assets relating to a particular class of business will be directly identifiable with that class of business. In addition, some assets may be specifically identified as shareholder assets. Sub-funds within a statutory fund may be established to enable this identification to be maintained on a robust, continuing and audited basis.

However, the nature of life insurance statutory funds is such that shareholders and policyholders will "share" the assets of a sub-fund.

We propose therefore that, for each sub-fund, all of the following be considered as divided between policyholders and shareholders in proportion to total income allocated during a period:-

(i) each of the amounts of interest, dividends and rents receivable during that period,

(ii) the amounts of gains realised during that period,

(iii) the amounts of unrealised gains arising during that period.

For this purpose,

(a) in the case of investment linked business, each fund established for an investment option will be considered as a sub-fund,

(b) a sub-fund is only recognised as such if clear rules for determining payments into and out of the sub-fund have been established, and audited accounts have been prepared.

This approach should provide a robust basis for allocation of the various components of investment income between shareholders and policyholders.

Transfers between Funds and Sub-funds

There will be occasions when transfers of assets between statutory funds and sub-funds will be made. In some cases, the transfer will be from or to a fund or sub-fund where the policyholders' income is taxed at a different rate from the corporate rate.

An issue arises as to the rate/amount of tax on the gain or loss when an asset, which has been the subject of earlier transfer, is sold.

To avoid any opportunity for manipulation, it is proposed that transfer of an asset between statutory funds or sub-funds be treated as a taxable event.

Life company rules demand that such transfers be carried out on an arms-length basis.

Accordingly, tax would be assessed on the gain (or loss) on transfer at the "old" (sub) fund tax rate. The amount paid on transfer will then be the base price for assessment of future gains or losses in the new (sub) fund.

Smoothing Reserves

Income which is allocated to "Smoothing Reserves" should be considered as allocated to policyholders, provided that it is clear that such income will only ever be reallocated to specific policyholders' accounts at a future date.

Franking Accounts

The paper envisages the establishment of two franking accounts – one for shareholders and one for policyholders.

The shareholders' franking account will operate for shareholder tax paid in respect of all the business of the life company. However, there should be a number of adjustments to the policyholders' franking account.

For superannuation business, including deferred annuity business and retirement savings accounts, Lend Lease/MLC has recommended that these be conducted on the same "tax paid" basis as currently applies. For these businesses, therefore, no franking account is required for policyholders. Accordingly, franking credits from policyholder tax attributable to this business should not arise.

In the case of immediate annuity business no tax is payable in the life company in respect of the investment return attributable to policyholders. Again, therefore, no franking account is required for policyholders.

Thus, policyholder franking credits will only arise for new Ordinary business. For existing business, which is to be "grandfathered" for policyholder tax purposes, no franking credits should arise.

As suggested by the RBT in paragraph 34.75, we accept that franking credits in respect of tax paid should be allocated between new Ordinary investment policies and shareholders in proportion to the allocation of tax for regulatory purposes. Similarly, franking credits attributable to dividends required should be allocated in proportion to the allocation of those dividends.

Expense Apportionments

In a life company, expenses are required by law to be apportioned on an equitable basis between (a) funds (i.e. shareholder and each statutory), (b) sub-funds, and (c) classes of business. Under the Life Insurance Act 1995, the apportionments must be approved by both the appointed actuary and the external auditor.

Under the proposed tax regime, all expenses for non participating business will be attributable to the shareholders, and those allowable as deductions will be deductible at the corporate rate regardless of the type of business.

The only issue with apportionment of expenses arises as between the non participating business and participating business where the policyholders effectively incur a (major) share. However, this is also the most important apportionment from the point of view of the regulator, who is concerned that life companies act in the best interests of their policyholders. With such a strong regulatory control, the opportunity for manipulation is negligible.

Accordingly, we submit that the Treasury should incorporate the use of the statutory apportionment for tax purposes.

Examples

Examples of the operation of Option 1, modified as suggested, are attached. These cover Investment Linked Business, Risk Business, Ordinary Participating Business and Immediate Annuity Business.

These show a split of statutory fund accounting items separately into those attributable to policyholders and shareholders.

They also demonstrate that the tax calculation using the Option 1 formula, modified as suggested, will result in total tax payable equal to tax at the corporate rate on shareholders' (distributable) profits, together with the taxation attributable to policyholders.

LIFE INSURANCE TAXATION – EXAMPLES:
INVESTMENT LINKED BUSINESS

		Statutory Fund		Policyholder "Accounts"		Shareholder Interest
Assets at Start of Period						
Represented by:						
- Solvency Requirement for Policies (SRP)		12850				-
- Deferred Tax Reserve		150				-
- Other		600				
- Total Liabilities and Capital		13600				
Unrealised Gains at Start		1430 (UG)		1300 (UGP)		130 (UGS)
Revenue Account						
Premiums		5000 (P)		5000 (P)		
Investment Income						
- Interest, Dividends, etc.		550		500		50
- Realised Gains	220		200		20	
less Unrealised amounts at start of period	(165)	55	(150)	50	(15)	5
- Unrealised Gains		275		250		25
- Total		880 (I)		800 (PI)		80 (SI)
Increase in Unrealised Gains		110 (ΔUG)		100 (ΔUGP)		10 (ΔUGS)
Fees		-		(130) (F)		130 (F)
Expenses		(95) (E)		-		(95) (E)
Policy Claims		(1400) (C)		(1400) (C)		-
Increase in Policyholders' Liabilities						
- Solvency Requirement		(4199) (ΔL)		(4199) (ΔL)		-
- Current Taxation [15% x (Inv. Inc. – Fees – Inc. Unreal. Gains)]		**(86) (PT)**		**(86) (PT)**		**-**
- Deferred Tax Reserves		(15) (ΔDTRP)		(15) (ΔDTRP)		-
- Total		(4300)		(4300)		-
Increase in Shareholders' Commitment to meet Solvency Requirement				30		(30)
Shareholders' "Profit" Before Tax		85		-		85
Shareholders' Taxation [(36% x (Shareholders' Profit less increase in Shareholders' Unrealised Gains ΔUGS) = 0.36 x (85 – 10)]		**(27)**				**(27)**
Shareholders' "Profit" After Tax		58				58
Total Tax payable by Company		**113**		**86**		**27**

Life Company Taxation – Example – Investment Linked Business

Ralph Committee Paper Option 1, with adjusted formula

<u>Shareholders' Taxable Income (STI)</u>

=	Premiums (P)	5000
+	Investment Income (I)	880

- Expenses (E)	(95)
- Policy Claims (C)	(1400)
- Increase in Policy Liabilities (Solvency Requirement) (ΔL)	(4199)
- Policyholders' Taxation (PT) 15% x (PI – F – ΔUPG)	(86)
- Increase in Policyholders' Deferred Tax Reserve (ΔDTRP)	(15)
- Increase in Unrealised Gains attributable to Shareholders (UGS)	(10)
Shareholders' Taxable Income	**75**
Policyholders' Taxable Income = (PI – F – ΔUGP)=(800 – 130 – 100)	**570**
Total Taxable Income	**645**
Shareholders' Tax = 75 x 0.36	**27**
Policyholders' Tax = 570 x 0.15	**86**
Total Life Company Tax	**113**

Notes:-

(1) Shareholder Investment Income includes both:-

(i) investment income on assets in excess of the Solvency Requirement for policies (SRP), and

(ii) all investment income from SRP assets, other than that which has been allocated to policyholders.

(2) The split of unrealised gains at the start of the period (UG) is between those allocated to policyholders (UGP) and the balance, i.e. allocated to shareholders (UGS).

(3) The increase in Shareholders' Commitment to meet the Solvency Requirement is the "balancing item" in the Policyholders' Accounts column.

LIFE INSURANCE TAXATION – EXAMPLE: RISK BUSINESS

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
Assets at Start of Period			
Represented by:			
- Solvency Requirement for Policies	4000		
- Other	600		
- Total Liabilities and Capital	4600		
Revenue Account			
Premiums	5000 (P)	5000 (P)	
Investment Income	250 (I)	220 (PI)*	30
Fees (including Underwriting Profit)	-	(2620) (F)	2620 (F)
Expenses	(2000) (E)	-	(2000) (E)
Policy Claims	(2400) (C)	(2400) (C)	-
Increase in Policyholders' Liabilities - Solvency Requirement	(300) (ΔL)	(300) (ΔL)	-
Increase in Shareholders' Commitment to meet Solvency Requirement		100	(100)
Shareholders' "Profit" Before Tax	550	-	550
Shareholders' Taxation [(36% x Shareholders' "Profit"]	**(198)**		**(198)**
Shareholders' "Profit" After Tax	352		352
Total Tax payable by Company	**198**	**-**	**198**

* This will not be recognised as income to policyholders on claim, so no tax has been deducted from the policyholders' "accounts". Income from the investments supporting the Solvency Requirement simply increases the "fee" (including profit) payable to the shareholders.

Life Company Taxation – Example – Risk Business

Ralph Committee Paper Option 1, with adjusted formula

<u>Total Taxable Income (TI)</u>

-	Premiums (P)	5000
+	Investment Income (I)	250
-	Expenses (E)	(2000)
-	Policy Claims (C)	(2400)
-	Increase in Policy Liabilities (Solvency Requirement)(ΔL)	(300)
=	**Total Taxable Income (all Shareholders')**	**550**
Life Company Taxation = 550 x 0.36 =		**198**

LIFE INSURANCE TAXATION – EXAMPLE: ORDINARY PARTICIPATING BUSINESS

		Statutory Fund		Policyholder "Accounts"		Shareholder Interest
Assets at Start of Period						
Represented by:						
- Solvency Requirement for Policies		9850				
- Deferred Tax Reserve		150				
- Other		1000				
- Total Liabilities and Capital		11000				
Unrealised Gains at Start		1430 (UG)		1300 (UGP)		130 (UGS)
Revenue Account						
Premiums		300 (P)		300 (P)		
Investment Income						
- Interest, Dividends, etc.		550		500		50
- Realised Gains	220		200		20	
less Unrealised amounts at start of period	(165)	55	(150)	50	(15)	5
- Unrealised Gains		275		250		25
- Total		880 (I)		800 (PI)		80
Increase in Unrealised Gains		110 ΔUG		100 ΔUGP		10 (ΔUGS)
Expenses		(105) (E)		(105) (E)		-
Policy Claims		(1000) (C)		(1000) (C)		-
Decrease (Increase) in Policyholders' Liabilities						
- Solvency Requirement		341 (ΔL)		341 (ΔL)		-
- Current Taxation [36% x (Inv. Inc. – Fees – Expenses – Inc. in Unreal. Gains)]		**(166) (PT)**		**(166) (PT)**		**-**
- Deferred Tax Reserve		(25) (ΔDTRP)		(25) (ΔDTRP)		-
- Total		150		150		-
"Fees " (= Shareholders' share of investment income plus profits)		-		(135) (F)		135 (F)
Decrease in Shareholders' Commitment to meet Solvency Requirement				(10)		10
Shareholders' "Profit" Before Tax		225		-		225
Shareholders' Taxation [(36% x (Shareholders' Profit less increase in Shareholders' Unrealised Gains (UGS)]		**(77)**				**(77)**
Shareholders' "Profit" After Tax		148				148
Total Tax payable by Company		**243**		**166**		**77**

Life Company Taxation – Examples – Ordinary Participating Business

Ralph Committee Paper Option 1, with adjusted formula

Shareholders' Taxable Income (STI)

=	Premiums (P)	300
+	Investment Income (I)	880

- Expenses (E)	(105)
- Policy Claims (C)	(1000)
+ Decrease in Policy Liabilities (Solvency Requirement) (ΔL)	341
- Policyholders' Taxation (PT) 36% x (Inv. Inc. – Fees – Expenses – Inc. in Unreal. Gains)	(166)
- Increase in Policyholders' Deferred Tax Reserve (ΔDTRP)	(25)
- Increase in Unrealised Gains attributable to Shareholders (UGS)	(10)
Shareholders' Taxable Income	**215**
Policyholders' Taxable Income = (PI – E – F – ΔUGP)=(800 – 135 – 105 – 100)	**460**
Total Taxable Income	**675**
Shareholders' Tax = 215 x 0.36	**77**
Policyholders' Tax = 460 x 0.36	**166**
Total Life Company Tax	**243**

Notes:-

This example is of a declining fund, with decreasing policyholder liabilities.

Being a participating fund, the major part of the prudential margins in the Solvency Requirement are supported by Policyholders' Retained Profits. Hence the decrease in the shareholders' commitment to meet the Solvency Requirement is relatively small, but still contributes to shareholders' taxable income. This is identified in the breakdown on the previous page, and is included automatically in the modified Option 1 calculation above.

LIFE INSURANCE TAXATION – EXAMPLE: IMMEDIATE ANNUITY BUSINESS

		Statutory Fund		**Policyholder "Accounts"**		**Shareholder Interest**
Assets at Start of Period						
Represented by:						
- Solvency Requirement for Policies		11000				
- Other		600				
- Total Liabilities and Capital		11,600				
Unrealised Gains at Start		110 (UG)		100 (UGP)		10 (UGS)
Revenue Account						
Premiums		0 (P)		0 (P)		
Investment Income						
- Interest, Dividends, etc.		660		600		60
- Realised Gains	110		100		10	
less Unrealised amounts at start of period	(55)	55	(50)	50	(5)	5
- Unrealised Gains		220		200		20
- Total		935 (I)		850 (PI)		85 (SI)
Increase in Unrealised Gains		165 ΔUG		150 ΔUGP		15 (ΔUGS)
Fees (including Underwriting Profit)		-		(80) (F)		80 (F)
Expenses		(60) (E)		-		(60) (E)
Annuity Payments		(900) (C)		(900) (C)		-
Decrease (Increase) in Policyholders' Liabilities - Solvency Requirement		140 (ΔL)		140 (ΔL)		-
Decrease in Shareholders' Commitment to meet Solvency Requirement				(10)		10
Shareholders' "Profit" Before Tax		115		-		115
Shareholders' Taxation [(36% x (Shareholders' Profit less increase in Shareholders Unrealised Gains)]		**(36)**				**(36)**
Shareholders' "Profit" After Tax		79				79
Total Tax payable by Company		**36**		**-**		**36**

Life Company Taxation – Example –Immediate Annuity Business

Ralph Committee Paper Option 1, with adjusted formula

<u>Shareholders' Taxable Income (STI)</u>

=	Premiums (P)	-
+	Investment Income (I)	935
-	Expenses (E)	(60)
-	Policy Claims = Annuity Payments	(900)
+	Decrease (Increase) in Policy Liabilities (Solvency Requirement) (ΔL)	140
-	Policyholders' Taxation (PT) (0%)	0
-	Increase in Policyholders' Deferred Tax Reserve (ΔDTRP)	0
-	Increase in Unrealised Gains attributable to Shareholders (UGS)	(15)
Shareholders' Taxable Income		**100**
Policyholders' Taxable Income (0%)		**0**
Total Taxable Income		**100**
Shareholders' Tax = 100 x 0.36		**36**
Policyholders' Tax		**0**
Total Life Company Tax		**36**

Notes:-

(1) Investment Income allocated to policyholders is:-

(i) the amount expected to be earned under the policy contracts, plus

(ii) the policyholders' share of the balance of the income earned in the fund, on the basis that the total allocated to Policyholders = total fund income x current termination values/total net assets.

(2) The split of unrealised gains at the start of the period (UG) is between those allocated to policyholders (UGP) and the balance, i.e. allocated to shareholders (UGS).

(3) The increase in Shareholders' Commitment to meet the Solvency Requirement is the "balancing item" in the Policyholders' Accounts column.